Supreme Court, U.S.
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No. 02-

IN THE

Supreme Court of the United States

GREG SEINFELD,

Petitioner,

v.

CAROL A. BARTZ; JOHN T. CHAMBERS; MARY A. CIRILLO; JAMES F. GIBBONS; EDWARD R. KOZEL; JAMES C. MORGAN; JOHN P. MORGRIDGE; ARUN SARIN; DONALD T. VALENTINE; STEVEN M. WEST; and CISCO SYSTEMS, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900

181017

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

QUESTION PRESENTED

An important purpose of the Securities Exchange Act of 1934 is to promote honest and efficient stock and securities markets through informed investor decision by requiring full and fair disclosure, especially of financial information. Section 14(a) of the Act addresses this purpose by requiring fair corporate suffrage, which has been historically and still is essentially unprotected by state law. Accordingly, where a proxy statement solicits corporate stockholders to vote to approve a plan for the company to grant stock options, even if the annual cost of the options is 10 or 20 times the annual cash retainer to the directors, as reported in that proxy statement,

Does § 14(a) not require the proxy statement to disclose the cost of the stock options, either because:

1. Corporate stock options cannot be evaluated by Black-Scholes or any other way; or

2. There is no rule that requires such disclosure *in haec verba*, as it might for "children in kindergarten?"

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Appendix C — Statutory And Regulatory Provisions Involved 26a

Greg Seinfeld petitions the Supreme Court of the United States for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 322 F.3d 693 (9th Cir. 2003) and reprinted at petitioner's appendix at 1a-13a. The opinion of the United States District Court for the Northern District of California dismissing the complaint is reported at 2002 WL 243597 (N.D. Cal. 2002) and reprinted at petitioner's appendix at 14a-25a.

STATEMENT OF JURISDICTION

The Court of Appeals entered judgment on March 7, 2003. The jurisdiction of this court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES, RULES, AND REGULATIONS INVOLVED

The Securities Exchange Act of 1934, § 14(a)
15 U.S.C. § 78n(a);

Securities and Exchange Commission Rules and Regulations
Rule 14a-9, 17 C.F.R. § 240.14a-9;

Schedule 14A, Items 8 and 10,
17 C.F.R. § 240.14a-101 (Item 8)(a), (b), and (d)
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Regulation S-K, Items 402(c) and 402(g),
17 C.F.R. § 229.402(c)(1) without Table,
(c)(2)(vi)(B), and Instruction 9;
17 C.F.R. § 229.402(g) and Instruction.

These provisions are lengthy and are reprinted in the petitioner's appendix at 26a.

STATEMENT OF THE CASE

The lower court, after repeated disparagement of Black-Scholes, concluded its opinion with the suggestion that stockholders should ask the SEC to require a Black-Scholes disclosure of stock option values in a proxy statement whenever it seeks stockholder approval of stock options. (12a) We suggest that this disparagement materially weakens any rule that the SEC might make. More seriously, it weakens existing rules that do require its use in corporate earnings statements and other applications, characterized as important by, *inter alia*, Federal Reserve Chairman Alan Greenspan.

This an action by a stockholder of Cisco Systems, Inc. ("Cisco" or the "Company") against its directors for distributing a false and misleading proxy statement. All ten individual defendants are directors of Cisco. Seven of them are non-employee directors.

As a part of Cisco's 1996 Stock Incentive Plan (the "Plan"), the board of directors included the Automatic Option Grant Program (the "Program"). The Program provides for an automatic, initial grant of an option to purchase shares of the Company's stock to each new non-employee director and an automatic, subsequent, annual grant of an option to purchase shares of the Company's stock to each re-elected non-employee

director on the date of re-election. The options are exercisable at the market price of the underlying stock on the date of grant. The options expire nine years from the date of grant or 12 months following termination of board service, whichever is earlier.

On July 8, 1999, the board of directors approved the Amendment to the Program. (E-75) Pursuant to the Amendment, the initial grant would increase from 20,000 to 30,000 shares, and the annual grant would increase from 10,000 to 15,000 shares. (E-3)

The complaint alleges that the defendants used a materially false and misleading Proxy Statement for the 1999 annual meeting to obtain stockholder approval of the Amendment. The Proxy Statement represents that each Non Employee Director was paid $32,000 per year plus options on 10,000 shares of the Company's stock for the fiscal year ending ("FYE") July 31, 1999 (E-4). The Proxy Statement did not disclose the fair value of the options granted in FYE 1999, *i.e.*, $369,500 (E-5). If the Amendment had been effective in FYE 1999, the value of each non-employee director's option would have been $554,250, 17 C.F.R. § 240.14a-101 (Item 10)(a)(2)(iii)(C) and Instruction 2, 32a, and with the $32,000 retainer, $586,250 (E-9). As a result of the stockholders' approval of the Amendment, the total annual compensation of each Non Employee Director in FYE 2000 was not $32,000, but $753,800.

The complaint, at ¶27, understates the value of a non-employee director's FYE 2000 compensation as increased by the Amendment, alleging that the value of each 15,000 share option was $630,900, when it was actually $721,800, and added to $32,000 it is $753,800. The understatement resulted from using the wrong pre-split price, *i.e.*, the complaint says "69.50

per share", instead of $79.50, the product of 2 times $39.75. See Cpl. ¶16 (E-4), ¶27 (E-9), and the historical post-split price table at November 10, 1999 (E-44). This was the compensation to each non employee director for eight meetings, and they need not have attended every single one to get paid this much.

The complaint, at ¶¶18, 21, (E-5, 6) alleges that the Company itself evaluates the stock options that it grants and that it uses the Black-Scholes option pricing model. Thus, the Company's Form 10K for its fiscal year ending July 31, 1999, in note 9 to its financial statements, states, "[T]he fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions (then listed). . . ." (E-79).

The Proxy Statement could have included the values of the stock options granted to the non-employee directors in FYE 1999, for the numbers actually existed in the Company's possession. (Cpl. ¶¶16-18; (E-4, 5)). Accordingly, there was no need to make calculations, for that work had already been done. All that was required was to share it with the stockholders.

The lower court rejected application of the Black-Scholes option pricing model to the stock options at bar and affirmed dismissal of the complaint for failure to state a claim. It also failed to consider pertinent rules and regulations of the United States Securities and Exchange Commission (sometimes "SEC" or "Commission"). It also undertook to decide upon the application of a Generally Accepted Accounting Principle ("GAAP") without a record of expert testimony.

REASONS FOR GRANTING THE PETITION

Alan Greenspan, Chairman of the Federal Reserve System, said that disclosure of the cost of corporate stock options is an issue of national importance. The Financial Accounting Standards Board is considering whether to require it. What they are talking about is the expensing of stock options on corporate income statements, an intricate, complicated matter involving questions of timing and how to phase it in. It is much more difficult to perfect than the Question Presented in this petition for certiorari, but they are equally important in that they each require the evaluation of stock options under a pricing model such as Black-Scholes, and they each affect a material amount of American wealth, assets, and capital.

The Question Presented is an issue that should be settled by this court. The principal reason is that the Ninth Circuit, as well as other lower federal and state courts, have uttered such substantial disparagement of Black-Scholes, and the evaluation of corporate stock options in general, that they seriously compromise FASB's work. That disparagement is unscientific, ahistorical, and anti- intellectual, but too many judges have accepted it. Meanwhile, out capital markets bear the burden.

1. The Question Presented Is An Important Question Of Federal Law

"[A]n issue of national concern" is what Federal Reserve System Chairman Alan Greenspan said of the possibility that the financial markets do not understand the cost of stock options granted to corporate employees, officers, and directors. He said, "[M]arket values are distorted and real capital resources are being diverted from their most efficient employment." (Submission by Robert H. Herz, Chairman, Financial Accounting Standards

Board, for the Roundtable on *Preserving Partnership Capitalism Through Stock Options For America's Workforce* at the United States Senate, p. 26, May 8, 2003.) (http://www.fasb.org/full_text.pdf). Chairman Greenspan also said, "The notion that you can't value options is flat wrong." *The Wall Street Journal*, p. C-3, May 9, 2003.

Chairman Greenspan was speaking in the context of expensing stock options on corporate income statements. The expensing of stock options occurs long after a stock option plan is approved. Expensing is done during the period from the date that the stock option is granted until it becomes fully vested. (FASB 123 ¶30.) We submit that his remarks are even more pertinent to stockholder approval of the plans under which many stock options are granted, for it precedes the grant of stock options. It is the only time that corporate stockholders get to vote on the matter.

The solicitation of stockholder approval of stock option plans is a frequent event. Solicitations appear in approximately 45 percent of proxy statements, according to Institutional Shareholder Services, Inc., of Rockville, Maryland, the leading proxy statement review firm. *ISS, Setting The Bar For Executive Pay* (http://www.issproxy.com/pdf/Compensation% 20Guidelines.pdf). There are perhaps 10,000 United States companies that solicit annual proxies. *About ISS — Company Profile* (http://www.issproxy.com/about/index.asp). The NASDAQ National Market lists more than 4,000 companies. *About NASDAQ* at 1 (http://www.nasdaq.com/about/about_nasdaq.stm). The New York Stock Exchange lists approximately 2,800 companies. *NYSE Listed Companies* (http://www.nyse.com/listed/1020656067970.html). The grant of options on the stock of publicly held companies to directors and employees has increased. Perry and Zenner, "*CEO Compensation In The 1990s: Shareholder Alignment or Shareholder Expropriation?*" 35 Wake Forest L. Rev. 123 (2000). Data

collected by the United States Department of Labor, Bureau of Labor Statistics, as part of its National Compensation Survey, reveal that in 1999, stock options were granted by 30.5 percent of publicly held companies with more than 100 employees. Crimmel and Schildkraut, "*Stock Option Plans Surveyed By NCS*," *Compensation and Working Conditions*, page 11, table 3, (Spring 2001) (http://www.bls.gov/opub/cwc/archive/spring2001artl.pdf). The percentage of employees receiving stock options pursuant to plans during "normal tenure on the job" was mostly in the 80 to 100 percent range. Crimmel and Schildkraut, at page 14, table 6 n.1.

As Institutional Shareholder Services reports, the cost of a stock option plan to a company and its stockholders can be substantial. *ISS, Setting The Bar For Executive Pay*, *supra* at 3 (Example B). They characterize it as being "among the *most economically significant issues* upon which shareholders are entitled to vote [Italics in original] (*Idem.* at 1). The value of stock held by the public is substantial. The New York Stock Exchange reports that the 2,800 companies listed there have an aggregate value of approximately $13.5 Trillion. *NYSE Listed Companies*, *supra*. In *Kalageorgi v. Victor Kamkin, Inc.*, 750 A.2d 531, 538 (Del. Ch. 1999), *aff.*, 748 A.2d 913 (Del. 2000), the court observed:

> Corporate securities are a species of property right that represent not only a firm's fundamental source for raising capital, but also now a publicly traded commodity that is a critical component for creating both institutional and individual wealth that may affect the economic well-being of entire societies.

The court went on, "calling capital stock 'a species of property right' that is of 'foundational importance . . . to our economic system'." *Grimes v. Alteon, Inc.*, 804 A.2d 256, 260 n.6 (Del. 2002).

2. This Question Should Be Settled By This Court

Only the Supreme Court can do it, for no one else is addressing it except the lower federal courts and the state courts. The issue is not before the Financial Accounting Standard Board, who are instead considering what to do after the plans are approved and the stock options are granted, *i.e.*, whether to require that stock options be expensed. FASB News Release 03/12/03 (http://www.fasb.org/news/nr031203.shtml). Institutional Shareholder Services, Inc. does address this issue, but only for a small fraction of investors, *i.e.*, its 950, or so, institutional clients. *About ISS*, *supra*.

Only the courts have addressed this issue and only at the urging of petitioner's counsel. *See Shaev v. Hampel*, 2002 WL 31413805 at *5 n.8 (S.D.N.Y. 2002). The decisions have all been wrong and for a variety of bad reasons.

The earliest cases to reject a Black-Scholes disclosure requirement were based largely on the theory that director and officer stock options could not be evaluated. *Resnik v. Swartz*, 2001 WL 15671 at *1 (S.D.N.Y. 2001) (Black-Scholes value of a stock option "can only be described as a best guess"); *In re 3Com Corp. Sh.Lit.*, 1999 WL 1009210 (Del. Ch. 1999) (as to Black-Scholes, we have "consistently taken a rather jaundiced view of the valuations and their reliability," at *4 n.17, "the Black-Scholes Option Pricing Model is neither sufficiently reliable nor necessary to apprise shareholders of the value of the options in question," at *6); *Cohen v. Calloway*, 246 A.D.2d 473, 667 N.Y.S.2d 249 (1st Dept. 1998) (it is "so imprecise that its inclusion probably would have done more harm than good").

The first case was *Lewis v. Vogelstein*, 699 A.2d 327, 331-32 (Del. Ch. 1997). There the court announced, 699 A.2d at 331:

> Significant doubt exists whether the Black-Scholes option-pricing formula or other, similar option-pricing models, provide a sufficiently reliable estimate of the value of the options with terms such as those granted to the outside directors of Mattel. [Footnote omitted.]

The court went on to explain that the Black-Scholes model posits publicly traded or assignable options, and it held that early exercise will further reduce their value.

The "[s]ignificant doubt" expressed by the court on the reliability of stock option evaluations is "flat wrong" according to Chairman Greenspan (*The Wall Street Journal*, *supra*) and the unassignability of stock options is irrelevant, for that does not affect the cost to issue them. Bodie, Kaplan, Merton, "*For The Last Time: Stock Options Are An Expense*", Harvard Bus. Rev., March 1, 2003, 2003 WL 9953511 at page 4. Moreover, the cost reduction of early exercise is "significantly overstate[d]." (*Idem.* at page 12) One of the authors of this Harvard Bus.Rev. article, Dr. Merton, shared in one half of the 1997 Nobel Prize in Economic Science, with Dr. Scholes, for his work on the Black-Scholes option pricing model (http://www.nobel.se/economics/laureates/1997/index.html). Fischer Black died in 1995 (E-74).

For the courts to accept the argument that Black-Scholes disclosures are unreliable is to accept "expertise that is *fausse* and science that is junky." *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137, 159 (1999) (concurring opinion of Justices Scalia, O'Connor, and Thomas).

The lower court held that these four cases were not inconsistent with *Custom Chrome, Inc. v. Comm.*, 217 F.3d 1117, 1124 n.10 and accompanying text (9th Cir. 2000) (Black-Scholes option pricing model is "well established and reliable" and capable of determining the value of stock options with "reasonable accuracy.") (6a-7a.) The lower court held that its decision in "*Custom Chrome* in no way endorses the use of Black-Scholes to value options granted to outside directors." (7a.) The lower court affirmed the district court's reliance on "all four of these cases [that] held that Black-Scholes valuations are not material as a matter of law." (18a-19a.) But to the extent that the four cases addressed materiality, they substantially relied on the belief that Black-Scholes was plagued by significant doubt as to its reliability, a belief that is refuted by Chairman Greenspan and Dr. Merton.

The lower court, 9a-10a, evinced a further disagreement with the Financial Accounting Standards Board in failing to reject the Proxy Statement representation that a stock option has "no value," 9a, unless the stock price increases. FASB 123, ¶¶139-42; Ciesielski, "*Another Options War*," Barron's, p.39 (May 5, 2003) available at 2003 WL-Barron's 6977368; Thomas and Martin, "*The Determinants of Shareholder Voting On Stock Option Plans*," 35 Wake Forest L. Rev. 31, 41 (2000) ("Valuing a stock option requires using the Black-Scholes formula and is not an intuitive process. [Footnote omitted]").

Like some other courts, the Ninth Circuit suggested that the Securities and Exchange Commission formulate a rule on this issue, 12a, citing *Resnik v. Swartz*, 303 F.3d 147, 154-55 (2d Cir. 2002), which in turn, borrowed the idea from *Lewis v. Vogelstein, supra*, 699 A.2d at 332-33. But, after the lower court, like so many other courts, held that Black-Scholes does not work on these stock options (and decided it as a matter of

law on a motion to dismiss for failure to state a claim), no rule from the Commission or FASB would be free of suspicion by the public, unless this court decides that those courts are wrong.

The lower court held that the proxy statement complied with 17 C.F.R. § 240.14a-101 (Item 8) which refers to 17 C.F.R. §§ 229.402(c) and (g). (8a-9a.) It noted that Item 402(c), 32a-34a, expressly provides for Black-Scholes disclosures in proxy statements, but only for executive officers and not directors. On the other hand, § 402(g), 34a-35a, concerns proxy statement disclosure of directors' compensation, but omits references to Black-Scholes evaluations.

The lower court overlooked 17 C.F.R. § 240.14a-101 (Item 10), 29a-31a, concerning stockholder voting on new compensation plans for, *inter alia*, directors. It requires that the proxy statement disclose the "Dollar Value," 30a, of directors' "noncash compensation" if determinable, 29a. Item 10 expressly addresses the requirements for obtaining stockholder approval of new compensation plans, and it expressly contains the requirement to state the "Dollar Value" of non-cash benefits of the proposed new plan. Item 10 applies to directors, 30a, 31a, and is not limited solely to officers.

The lower court should not have used the principle *inclusio unius est exclusio alterius*, for §§ 402(c) and (g), without considering Item 10, nor where the result seems "to conflict with the objective of the statute it implements," *Sec. of Labor, Mine Safety & Health Admin. v. Western Fuels-Utah, Inc.*, 900 F.2d 318, 320 (D.C. Cir. 1990), i.e., the protection of investors. 17 C.F.R. § 240.14a-9, 27a; *see Zell v. Intercapital Income Securities, Inc.*, 675 F.2d 1041, 1044 (9th Cir. 1982); *Maldonado v. Flynn*, 597 F.2d 789, 796 n.9 and accompanying text (2d Cir. 1979). In *Shook v. D.C. Financial Responsibility*

& Mgmt. Asst. Auth., 132 F.3d 775, 782 (D.C. Cir. 1998) the court suggested its use "as a starting point in statutory construction — not as a close-out bid." *See also Cheney R. Co. v. ICC*, 902 F.2d 66, 68-69 (D.C. Cir. 1990).

The lower court's statement that FASB 123 is only concerned with accounting in financial statements for options granted as compensation, and that it does not address proposed compensation in a proxy statement (7a-8a), is inconsistent with the position of the SEC that financial information should be reported using GAAP, *i.e.*, Generally Accepted Accounting Principles, even if it is not in "financial statements." *Matter of Trump Hotels & Casino Resorts, Inc.*, 2002 WL 58566 ¶III A-D (SEC Rel. No. 34-45287, January 16, 2002) ("using that non-GAAP figure [in a press release] was materially false"). As FASB 123 ¶149, states, corporate stock options are equity instruments. As such, they must be reported, wherever disclosed, consistently with GAAP according to FASB.

FASB 123 includes a thorough explanation of stock options and what they are worth and why. It quantifies its observations and conclusions and in no way is limited to financial statements. It reflects the way the world of corporate compensation actually works. No corporate human resources department and no compensation consultant would propose any stock option grant or stock option plan without making a fair value assessment, either using Black-Scholes or some similar method. (FASB 123 ¶373.) The lower court should have refrained from adjudicating the scope of FASB 123 in the absence of expert accounting testimony (*SEC v. Caserta*, 75 F. Supp. 2d 79, 90-92 (E.D.N.Y. 1999) ("a fact-specific issue" *Id.* at 91)), for the issue presented is whether the information is consistent with GAAP.

The development of FASB 123 was a project that extended from 1984 to 1995, and many opinions were considered. (FASB 123 ¶¶365-79.) FASB statements are part of and constitute the primary level of GAAP. In Accounting Series Release No. 150, Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, 39 F.R. 1260 [1937-1982 Transfer Binder, Accounting Series Releases], Fed. Sec. L. Rep. (CCH) ¶72,172 (Dec. 20, 1973), the SEC endorsed the establishment of FASB and said that its Statements and Interpretations will be considered as having substantial authoritative support, and those contrary to them will be considered to have no such support. The SEC has recently reconfirmed its support for FASB. SEC Rel. Nos. 33-8221; 34-47743; IC 26028; FR-70 (April 25, 2003) (http://www.sec.gov/rules/policy/33-8221.htm).

There is no need for the SEC to follow the courts' recommendation to make a new rule for disclosure. The SEC has already done that. Section 14(a), 26a, of the 1934 Act and Rule 14a-9, 17 C.F.R. § 240.14a-9, 27a, require full and fair disclosure of all material facts. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964) (§ 14(a) prevents "inadequate disclosure in proxy solicitation"); *Shaev. v. Saper*, 320 F.3d 373, 379 (3d Cir. 2003) ("a highly important rule in the corporate life of this nation"); Aranow and Einhorn, "*Proxy Regulation: Suggested Improvement*," 28 Geo. Wash. L. Rev. 306 (1959) ("the states did nothing to cope with the problem," at p. 306). Item 402(g), 34a, of Regulation S-K requires disclosure of the amount of directors' compensation. Item 10, 29a, 30a, of Schedule A requires disclosure of the Dollar Value of non-cash benefits. The SEC requires that financial information be disclosed according to Generally Accepted Accounting Principles, and the SEC says that FASB is the leading authority on those Principles, and FASB says to use an option pricing model to disclose the

value of stock options, and the federal courts have consistently held that directors' compensation is material. This is particularly so at bar where the directors have voted themselves annual stock options worth more than 20 times the annual cash retainer and without the advice of an independent consultant. Gershon Aff. ¶9, Exh. 7 (E-55, 75).

If the defendants were actually "children in kindergarten", they might be allowed to adhere to an honest belief that a hyper-literal reading of Reg. S-K and Schedule 14A, in isolation from all other learning, excuses disclosure, but we submit that they should be treated as adults and should be held to at least as high a standard as their stockholders. *Richland v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) (perhaps the first formulation of this idea).

FASB 123, at ¶373, reports that Black-Scholes values of stock options are widely used to design compensation packages. As the result of the lower court's decision, although insiders get a prior view of the value of the stock options, the stockholders, who are solicited to approve them and who must indirectly pay the cost of that value, do not.

The purpose of the SEC proxy statement rules and regulations are to inform the stockholders so that they can "vote prudently." *Galef v. Alexander*, 615 F.2d 51, 63 (2d Cir. 1980). The regulations have become exceedingly intricate over the years, for the SEC has tried to combine a system of uniform and consistent presentation with full and fair disclosure. These complicated regulations are not a game to be played for its own sake, the point being to beat the system, *i.e.*, to disclose the facts, but to delete the truth. We submit that the time is over for corporate games. *No. 84 Employer Teamster Fund v. America West Holding Corp.*, 320 F.3d 920, 946 (9th Cir. 2003);

Houbigant, Inc. v. Deloitte & Touche, LLP, 753 N.Y.S.2d 493, 498 (1st Dept. 2003). SEC Commissioner Cynthia A. Glassman, *Speech: Improving Corporate Disclosure — Improving Shareholder Value*, April 10, 2003 (http://www.sec.gov/news/speech/spch041003cag.htm) at page 3 of 9, said:

> GAAP's complex of rules creates situations where lawyers and accountants may play games with the rules, rather than focusing on the principles underlying them. The more specific the rules, the easier companies may find it to structure transactions specifically to circumvent them. This, of course, if the problem with "bright line" rules: the impulse is to make sure the line isn't crossed instead of making sure the books reflect the true economic condition of the company.

What Commissioner Glassman said of the rules of Generally Accepted Accounting Principles could as easily be said of the rules of the Securities and Exchange Commission.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT FILED MARCH 7, 2003

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 02-15498
D.C. No.
CV 01-2259 TEH

GREG SEINFELD,

Plaintiff-Appellant,

v.

CAROL BARTZ; JOHN T. CHAMBERS; MARY CIRILLO; JAMES F. GIBBONS; EDWARD KOZEL; JAMES C. MORGAN; JAOHN P. MORGRIDGE; DONALD VALENTINE; STEVEN M. WEST; CISCO SYSTEMS, INC.,

Defendants-Appellees.

Appeal from the United States District Court for the Northern District of California
Thelton E. Henderson, District Judge, Presiding

Argued and Submitted
December 5, 2002—San Francisco, California

Filed March 7, 2003

Appendix A

Before: Melvin Brunetti and A. Wallace Tashima, Circuit Judges, and David Alan Ezra, District Judge.*

Opinion by Judge Tashima

* * *

OPINION

TASHIMA, Circuit Judge:

Plaintiff-Appellant Greg Seinfeld appeals an order of the district court dismissing his action for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6). Seinfeld, a shareholder of Cisco Systems, Inc., filed a derivative action against Appellees, the company and its board of directors. In his complaint, Seinfeld alleged that Appellees violated § 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78n(a), and Rule 14a-9, 17 C.F.R. § 240.14a-9, by issuing a proxy statement that violated the proxy rules of the Securities and Exchange Commission ("SEC"). Specifically, Seinfeld contends that the proxy statement should have included the value of stock options granted to outside (non-employee) directors. The district court dismissed the complaint. We have jurisdiction pursuant to 28 U.S.C. § 1291, and we affirm.

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* The Honorable David Alan Ezra, Chief United States District Judge for the District of Hawaii, sitting by designation.

Appendix A

BACKGROUND

Seinfeld has been a stockholder of Cisco since August 20, 1998. In 1999, the board of directors sought to amend Cisco's Automatic Option Grant Program for outside directors, which is part of the company's 1996 Stock Incentive Plan. As the district court summarized it:

> The amendment, which was approved by shareholder vote at the November 1999 annual meeting, raised the number of stock options granted to outside directors upon joining the board from 20,000 shares to 30,000 shares. Additionally, the amendment raised the number of options granted annually to each continuing outside director from 10,000 shares to 15,000 shares.

Appellees prepared a proxy statement dated September 27, 1999, in which they solicited the company's stockholders' proxies for approval of the amendment.

Seinfeld filed a complaint in the United States District Court for the Southern District of New York,[1] alleging that the proxy statement contained "materially false and misleading statements and omit[ted] material facts," in violation of SEC proxy rules. He contended that the proxy statement should have included the value of the option grants based on the Black-Scholes option pricing model, a model

1. The district court in New York granted Appellees' motion to transfer the case to the Northern District of California, where the events at issue took place, and where Cisco's headquarters and nearly all the witnesses, evidence, and defendants are located.

allegedly used by Cisco in its annual financial statements and used by the Financial Accounting Standards Board ("FASB"), the SEC, and the Internal Revenue Service ("IRS"). According to the complaint, the Black-Scholes model "measures the cost to the grantor to grant the stock option, . . . commonly referred to as the fair value or the Black-Scholes value of the option," relying on values such as "the volatility of the underlying stock, the risk-free rate of interest, the expiry of the option, the dividends on the underlying stock, the exercise price of the option, and the market price of the underlying stock." According to Seinfeld's calculations, the value of the annual stock option granted to each director on September 27, 1999, the date of the proxy statement, was $1,020,600, and the value on November 10, 1999, the date of the grant, was $630,900. The proxy statement stated that each director was paid an annual retainer of $32,000, plus stock options. Seinfeld alleged that this statement was materially false and misleading because, according to his calculations, the directors actually received annual compensation of $410,500.

Seinfeld also challenged a representation in the proxy statement that, " '[u]nless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers.' " Seinfeld alleged that this statement was materially false and misleading because "the grant of stock options results in the immediate realization of value," which is best determined under the Black-Scholes model. Seinfeld further alleged that the proxy statement's representation of the tax consequences of the option grant was false because it failed to explain that stock options are taxable for federal estate

tax, gift tax, and generation-skipping transfer tax purposes and are valued using the Black-Scholes model.

The district court held that the Black-Scholes valuations of the option grants are not material facts that were required to have been contained in the proxy statement. The court further rejected Seinfeld's allegation that the proxy statement was misleading because it failed to disclose all federal tax consequences of the options. It therefore dismissed the complaint with prejudice in its entirety, pursuant to Rule 12(b)(6).

STANDARD OF REVIEW

The district court's dismissal under Rule 12(b)(6) for failure to state a claim is subject to de novo review. *Lipton v. Pathogenesis Corp.*, 284 F.3d 1027, 1035 (9th Cir. 2002). In reviewing a motion to dismiss, we must "take all well-pleaded allegations of material fact as true and construe them in the light most favorable to the plaintiff." *Desaigoudar v. Meyercord*, 223 F.3d 1020, 1021 (9th Cir. 2000), *cert. denied*, 532 U.S. 1021 (2001).

DISCUSSION

Section 14(a) of the Exchange Act makes it unlawful to solicit a proxy "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n(a). Rule 14a-9 prohibits the solicitation of a proxy by means of a proxy statement that contains a statement that "is false or misleading with respect to any

material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9(a). "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). "In addition, a Section 14(a), Rule 14a-9 plaintiff must demonstrate that the misstatement or omission was made with the requisite level of culpability and that it was an essential link in the accomplishment of the proposed transaction." *Desaigoudar,* 223 F.3d at 1022 (footnote and citation omitted).

The essence of Seinfeld's complaint is that the proxy statement was misleading because it did not include the Black-Scholes valuation of the options granted to the non-employee directors. He makes several different arguments in advocating the use of Black-Scholes. We conclude that SEC regulations do not require the use of the Black-Scholes valuation and that the proxy statement is not materially false and misleading. In so holding, we agree with the Second Circuit, which faced the same issue in *Resnik v. Swartz,* 303 F.3d 147 (2d Cir. 2002).

Seinfeld's first argument is that the district court erred in relying on four lower court cases to reject the use of the Black-Scholes valuation model because this is inconsistent with our "holding" in *Custom Chrome, Inc. v. Comm'r,* 217 F.3d 1117 (9th Cir. 2000), that Black-Scholes is reliable. We reject this argument because, not only is *Custom Chrome* inapposite, but this was not even a holding in *Custom Chrome.*

Appendix A

The issue in *Custom Chrome* was the value, for federal income tax purposes, of warrants, which are, "in essence, options," that were issued in connection with a loan transaction. *Id.* at 1120. In that case, we were required to determine, under the Internal Revenue Code, when the warrants should be valued and what their value should be for original issue discount ("OID") purposes.[2] *Id.* at 1121-23. We stated in a footnote that Black-Scholes is one of several "well-established and reliable methods" of valuing options for OID purposes. *Id.* at 1124 n.10. The issue was the value of warrants for OID purposes in the federal income tax context. *Custom Chrome* in no way endorses the use of Black-Scholes to value options granted to outside directors, and it certainly does not require the use of Black-Scholes to value options for purposes of a proxy statement. Its reasoning simply is inapposite to the issue presented here.

Seinfeld's second approach is to rely on FASB Statement No. 123, *Accounting for Stock-Based Compensation,* to argue that Black-Scholes is a reliable pricing model. FASB Statement No. 123 deals with the reporting of employee stock options in a company's financial statements for purposes of "arriving at reported earnings." *FASB's Plans Regarding the Accounting for Employee Stock Options* (July 31, 2002), *available at http://www.fasb.org/news/nr073102.shtml.* "There are salient differences, however, between financial statement disclosure of an estimated value of stock options under a plan and disclosure for the purpose of shareholder

2. "When a loan is provided at a face value higher than the amount actually loaned, the debtor is allowed to deduct the difference over the life of the loan as [OID], while the creditor realizes the OID as ordinary income." *Custom Chrome,* 217 F.3d at 1121.

ratification of adoption of the plan." *Lewis v. Vogelstein,* 699 A.2d 327, 332 (Del. Ch. 1997); *see also Resnik,* 303 F.3d at 153 (stating that FASB Statement No. 123 recommends recognizing "options' grant-date value as part of compensation expense" in financial statements but "does not purport to address the requirements for reporting proposed compensation in a proxy statement"). FASB Statement No. 123 is not pertinent.

Seinfeld also contends that director compensation is a material fact required to be disclosed under § 14(a) and that the proxy statement fails to comply with SEC regulation disclosure standards. These contentions fail. First, the proxy statement did disclose director compensation.

Second, the proxy statement does comply with SEC regulation disclosure standards. Item 8 of Schedule 14A, 17 C.F.R. § 240.14a-101, dealing with the compensation of directors and executive officers, requires a proxy statement to furnish the information required by Item 402 of Regulation S-K, 17 C.F.R. § 229.402, if action is to be taken with regard to a compensation plan. Item 402(g) addresses the compensation of directors and requires the disclosure of compensation amounts, "including amounts payable for committee participation or special assignments," and "any other arrangements pursuant to which any director of the registrant was compensated." 17 C.F.R. § 229.402(g). As in *Resnik,* "[t]he description of the directors' standard fees and the options proposed to be awarded, as disclosed in the proxy statement . . . , plainly meets this basic requirement." 303 F.3d at 152. The proxy statement thus complies with SEC regulation disclosure standards.

Moreover, contrary to Seinfeld's contention, "neither subsection (g), nor any other provision of Item 402 expressly requires disclosure of the grant-date value of stock options proposed to be provided to the directors." *Id.* The court in *Resnik* compared subsection (g) with subsection (c) of Item 402, which requires the disclosure of the value of options granted to certain executive officers and specifically states that Black-Scholes is one possible way of calculating the value of the grant on the grant-date. *Id.; see* 17 C.F.R. § 229.402(c). "The absence of any mention of option values or of valuation methods from subsection (g), Compensation of Directors, is persuasive evidence that the Commission did not intend subsection (g) to require disclosure of grant-date value calculation for the options proposed to be awarded to non-employee directors." *Resnik,* 303 F.3d at 152.

Seinfeld contends that the regulations are only minimum disclosure standards and that compliance with the regulations does not necessarily guarantee compliance with Rule 14a-9. He relies on *Zell v. InterCapital Income Sec., Inc.,* 675 F.2d 1041 (9th Cir. 1982), in which we stated that " 'Schedule 14A sets minimum disclosure standards. Compliance with this schedule does not necessarily guarantee that a proxy statement satisfied Rule 14a-9.' " *Id.* at 1044 (quoting *Maldonado v. Flynn,* 597 F.2d 789, 796 n.9 (2d Cir. 1979)).

In support of his argument, Seinfeld repeats the allegations of his complaint that the following representation in the proxy statement was materially false and misleading: "Unless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers." Seinfeld's only

argument that this is false and misleading, however, is that, according to FASB Statement No. 123, the options are best evaluated by the use of Black-Scholes. As discussed above, this FASB statement concerns financial statements, not proxy statements, and is not relevant to the issue presented here.

More importantly, the statement Seinfeld challenges is contained in a footnote to a table that lists option grants made in the last fiscal year to executive officers of the company, as required by Item 402(c), 17 C.F.R. § 229.402(c). Option grants that have already been made to executive officers are completely unrelated to the amendments to the plan Seinfeld is challenging, which concerned options proposed to be granted to outside directors. *Cf. Resnik,* 303 F.3d at 153-54 (rejecting a challenge to a similar statement, in part because, as here, the statement was contained in a footnote to a table describing options already granted to executives who were not covered by the plan at issue).

The facts of *Zell* are quite different from those presented here. In *Zell,* the plaintiffs charged the defendants, an investment fund, the investment manager, and the parent organization, with violations of § 14(a) and Rule 14a-9 by failing to disclose material information in two proxy statements. The proxy statements recommended approval of an agreement between the fund and a subsidiary of the parent, based in part on the parent's responsible management, financial strength, and investment skills. The proxy statements, however, failed to disclose that there were numerous lawsuits pending against the parent and the subsidiary charging violations of state and federal securities laws. We concluded that "it cannot be said that the omitted

information was so obviously unimportant that no reasonable Fund stockholders would consider it of actual significance in determining whether to approve" the agreement and therefore reversed the district court's grant of summary judgment in favor of the defendants. *Id.* at 1049. In finding the omitted information material, we reasoned that the proxy statements expressly relied on the corporations' financial stability and quality of management, that prior breaches of fiduciary duties or violations of securities laws "may have a direct bearing on managerial integrity," and that "[l]itigation involving substantial exposure to damages may affect a corporation's financial status." *Id.* at 1045-46.

The instant case does not present facts as compelling as those in *Zell.* In fact, the statement Seinfeld challenges as misleading is accurate; that is, the option grants made to the executive officers do not have value if the market price of the shares does not appreciate over the option term. *Cf. Resnik,* 303 F.3d at 154 (stating that a somewhat similar statement "accurately describes how value is realized when options are actually exercised").

Finally, Seinfeld contends that the proxy statement was misleading because it did not disclose federal estate, gift, and generation-skipping transfer tax consequences of the option grants. He argues that the IRS uses Black-Scholes to value stock options, citing in his complaint Rev. Rul. 98-21, 1998-1 C.B. 975, and Rev. Proc. 98-34, 1998-1 C.B. 983. The IRS publications to which Seinfeld refers deal with the valuation of stock options for federal transfer tax purposes; they have nothing to do with the valuation of options for purposes of disclosures in a proxy statement.

See Rev. Rul. 98-21 (describing the issue as the time that "the transfer of a nonstatutory stock option . . . by the optionee to a family member, for no consideration" becomes a "completed gift" under the Internal Revenue Code); Rev. Proc. 98-34 § 3 ("This revenue procedure applies only to the valuation for transfer tax purposes of nonpublicly traded compensatory stock options . . . ."). Seinfeld cites no law or SEC regulation that requires the disclosure in a proxy statement of federal transfer tax consequences of option grants to outside directors. Nor does he explain how the failure to discuss federal transfer tax consequences was a material omission. As the district court also reasoned, Appellees have not "falsely stated that the options have no consequences under these three tax schemes."

CONCLUSION

Even if we take all of the well-pleaded allegations of material fact as true and construe them in the light most favorable to Seinfeld, *see Desaigoudar,* 223 F.3d at 1021, he has not shown that the proxy statement made materially false or misleading statements or contained any material omission. The proxy statement complies with SEC regulations. "If appellant believes that Black-Scholes value disclosure should be mandatory whenever shareholders' approval is sought for a proposed option grant [to outside directors], his remedy is to advocate a change in the regulations before the [SEC]." *Resnik,* 303 F.3d at 155; *cf.* Rob Norton, *The Cure for Lavish Pay? Shame It to Death,* Wash. Post, Sept. 29, 2002, at B1, *available at* 2002 WL 101064666 (suggesting that the SEC could enact tougher standards for disclosure of corporate pay).

The judgment of the district court is **AFFIRMED**.[3]

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3. Appellees argue that Seinfeld's complaint fails to meet the pleading requirements of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b). We do not address this argument because, even "assum[ing] for purposes of this appeal that [Seinfeld's] pleadings are sufficient under the Act's requirements . . . the underlying facts cannot establish liability under Rule 14a-9, a conclusion that would not be altered by more detailed pleading." *Minzer v. Keegan*, 218 F.3d 144, 148 n.1 (2d Cir. 2000), *cert. denied*, 531 U.S. 1192 (2001).

APPENDIX B — ORDER OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA DATED AND FILED FEBRUARY 8, 2002

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA

NO. C01-2259 TEH

GREG SEINFELD,

Plaintiff,

v.

CAROL A. BARTZ, et al.,

Defendants.

ORDER

This matter came before the Court on January 28, 2002, on Defendants' Motion to Dismiss. Following oral argument, the Court issued its ruling from the bench GRANTING Defendants' motion with prejudice. This order describes the rationale for the Court's ruling in more detail.

FACTUAL BACKGROUND

Plaintiff is a shareholder of Defendant Cisco Systems, Inc. ("Cisco") and brings this suit as a derivative action against the company and its ten directors. At issue in this case is a 1999 amendment to Cisco's Automatic Option Grant Program for outside directors. The amendment, which was approved by shareholder vote at the November 1999 annual

meeting, raised the number of stock options granted to outside directors upon joining the board from 20,000 shares to 30,000 shares. Additionally, the amendment raised the number of options granted annually to each continuing outside director from 10,000 shares to 15,000 shares.

Plaintiff alleges that Defendants acted negligently in preparing their statement to solicit proxies to vote in favor of the amendment. The disputed proxy statement states that Cisco paid each outside director, except for Defendant Sarin, a $32,000 annual retainer fee for fiscal year 1999, and that it paid Defendant Sarin a $40,000 retainer fee to include board service commencing in September 1998. In addition, the statement represents that each director would receive periodic option grants under the Automatic Option Grant Program and was eligible to participate in the Discretionary Option Grant Program. The statement goes on to explain the number of options granted to each director, as well as the options' exercise prices and vesting requirements.

Plaintiff alleges that Defendants violated SEC proxy rules by failing to include the value of the option grants based on the theoretical Black-Scholes option pricing model. According to Plaintiff's Black-Scholes calculations, the value of the options granted to each of the continuing outside directors in 1998 was $369,500 on November 12, 1998 (the date of the grant) and $1,020,600 on September 27, 1999 (the date of the proxy statement). Plaintiff asserts that Cisco uses Black-Scholes to prepare its annual financial statements, and that it therefore would have been easy for Defendants to include the Black-Scholes valuations in the proxy statement. More significantly, Plaintiff alleges that Defendants'

statement of a $32,000 annual retainer fee plus stock options materially misrepresents the compensation of each outside director. Plaintiff contends that, using Black-Scholes, each director received compensation valued at well over $32,000.

In addition, Plaintiff alleges that the following sentence contained in the proxy statement is materially false and misleading: "Unless the market price of the Common Stock appreciates over the option term, no value will be realized from the option grants made to the executive officers." Plaintiff asserts that this statement is false because the grant of stock options results in the immediate realization of value, which is best determined using Black-Scholes. Moreover, Plaintiff contends that Defendants should have explained that stock options are valued using Black-Scholes for purposes of the federal estate tax, gift tax, and generation-skipping transfer tax, even if the options need not be so valued for purposes of the federal income tax.

LEGAL STANDARD

Dismissal is appropriate under Rule 12(b)(6) when a plaintiff's allegations fail to state a claim upon which relief can be granted.[1] Fed. R. Civ. P. 12(b)(6). In deciding whether a case should be dismissed, a court may generally only consider the complaint and any attached exhibits that have been incorporated therein. *See Lucas v. Dep't of Corrections,*

1. Defendants assert that the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) and the Private Securities Litigation Reform Act of 1995 apply to this case. The Court does not reach this issue because Plaintiff's claims fail to survive even the more lenient standards of Rule 12(b)(6).

66 F.3d 245, 248 (9th Cir. 1995) (considering material external to the complaint converts the motion into a Rule 56 summary judgment motion); *Parks Sch. of Bus., Inc. v. Symington,* 51 F.3d 1480, 1484 (9th Cir. 1995) (exhibits attached to the complaint and incorporated therein by reference are treated as part of the complaint for purposes of Rule 12(b)(6)). The court may also consider "documents whose contents are alleged in a complaint and whose authenticity no party questions, but which are not physically attached to the pleading." *Branch v. Tunnell,* 14 F.3d 449, 454 (9th Cir. 1994).

The court must accept as true the factual allegations of the complaint and construe those allegations in the light most favorable to the plaintiff. *Zimmerman v. City of Oakland,* 255 F.3d 734, 737 (9th Cir. 2000). It should not grant dismissal unless "it appears beyond a doubt that [the] plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Steckman v. Hart Brewing, Inc.,* 143 F.3d 1293, 1295 (9th Cir. 1998); *see also Conley v. Gibson,* 355 U.S. 41, 45-46 (1957). Moreover, dismissal should be with leave to amend unless it is clear that amendment could not possibly cure the complaint's deficiencies. *Steckman,* 143 F.3d at 1296.

DISCUSSION

Plaintiff alleges that Defendants negligently violated Section 14(a) of the Securities Exchange Act of 1934 and Rule 14a-9 of the Securities and Exchange Commission ("SEC"). Section 14(a) makes it unlawful to solicit proxies in violation of SEC rules. 15 U.S.C. § 78n(a) (2002). SEC

Appendix B

Rule 14a-9 prohibits solicitation of a proxy by a statement containing either (1) a false or misleading declaration of material fact or (2) an omission of material fact that makes any portion of the statement false or misleading. 17 C.F.R. § 240.14a-9 (2002).

An omitted fact is "material" if "there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). A plaintiff does not have to demonstrate that disclosure of the fact in question would have caused a reasonable shareholder to change his or her vote. *Id.* Instead, it is sufficient to establish a substantial likelihood that, "under all of the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder." *Id.* In other words, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Id.*

Failure to Include Black-Scholes Valuations in the Proxy Statement

Here, Plaintiff asserts that the Black-Scholes valuations of the option grants to the outside directors are omitted material facts. As Defendants point out, however, four courts that have considered Plaintiff's argument have rejected it at the pleading stage. *See Resnik v. Swartz*, No. 00 Civ. 5355 (LMM), 2001 WL 15671 (S.D.N.Y. Jan. 8, 2001); *In re 3Com Corp. Shareholders Litig.*, No. C.A. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Cohen v. Calloway*, 667 N.Y.S.2d 249 (N.Y. App. Div. 1998); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997). The courts in all four of these

cases held that Black-Scholes valuations are not material as a matter of law. To the parties' and the Court's knowledge, no court has ever held to the contrary. The *In re 3Com* court even explicitly considered—and rejected—the plaintiff's argument that the "options have no value unless the market price of the stock rises" statement was misleading. *In re 3Com,* 1999 WL 1009210 at *6-8.

While not controlling precedent, the above cases are highly persuasive because of the factual similarities they share with the instant case. In three of the four cases,[2] the plaintiff alleged violation of disclosure laws based on proxy statements that identified outside director compensation in terms of dollar-amount retainer fees and number of stock options, without providing any theoretical calculations. *In re 3Com* involved a substantially identical claim to Plaintiff's—i.e., failure to disclose Black-Scholes valuations of option grants when seeking proxies to approve increasing the number of stock options granted to directors. *In re 3Com,* 1999 WL 1009210 at *1-2. *Lewis* also concerned a nearly identical claim, with the only difference being that the case involved solicitation of proxies to adopt, rather than amend, a stock option plan. *Lewis,* 699 A.2d at 329-30.

Plaintiff attempts to distinguish the three state-court cases—but, notably, does not even mention *Resnik* in his written opposition[3]—on grounds that they were applying

2. The *Cohen* order does not include a factual background, but the legal analysis indicates a similar, if not identical, fact pattern to the instant case.

3. At oral argument, Plaintiff observed that *Resnik* is currently on appeal to the Second Circuit, suggesting that this Court should (Cont'd)

state, rather than federal, law. Plaintiff correctly points out that the plaintiffs in the Delaware cases alleged breach of the state-law-based duty of candor, and not the federally defined Rule 14a-9.[4] However, the New York and Delaware courts applied the same "materiality" standard that this Court is bound to apply under the U.S. Supreme Court's decision in *TSC Industries*.[5] Thus, the fact that the state cases addressed state-law causes of action does not require this Court to reject the analysis in those cases.

Plaintiff next argues that a Ninth Circuit case, *Custom Chrome, Inc. v. Commissioner of Internal Revenue*, 217 F.3d 1117 (9th Cir. 2000), requires this Court to break new ground and reject the decisions made by the four courts discussed above. In *Custom Chrome*, the Ninth Circuit noted in a

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(Cont'd)
therefore not consider the district court's ruling. However, the order of dismissal in *Resnik* still stands as good law; it has not yet been—and may never be—reversed. Moreover, even if the Court did not consider *Resnik*, Plaintiff would not gain any significant support. It would still be the case that the only courts to have considered claims similar to Plaintiff's have rejected such claims at the pleading stage.

4. The New York order does not specify plaintiff's claim, though this Court is willing to assume, as Plaintiffs argue and as Defendants do not dispute, that the claim was based on state law.

5. While the Delaware courts applied Delaware law to define "materiality," the Delaware standard is identical to that established in *TSC Industries*. *See In re 3Com*, 1999 WL 1009210 at *5. The New York court explicitly cited *TSC Industries* in its order. *Cohen*, 667 N.Y.S.2d at 249.

footnote that Black-Scholes was a reliable method of determining the value of the options at issue in that case. *Id.* at 1124 n.10. However, as Defendants correctly point out, the court explicitly distinguished the options at issue—which were issued as part of a loan transaction—from options granted for services rendered. *Id.* at 1122. In this case, Defendants received options for the services they rendered as Cisco's directors, and *Custom Chrome* is therefore distinguishable.

Custom Chrome is further distinguishable because tax regulations require that the options in that case be valued at the time of grant. *Id.* at 1122. Here, by contrast, nothing requires Defendants to calculate the value of the options at time of grant. Plaintiff argues that SEC regulations require Black-Scholes calculations, but he points to no specific regulation that requires them. Item 402(g) of Regulation S-K requires proxy statements to include information on the compensation of directors, but this regulation makes no mention of valuing options. 17 C.F.R. § 229.402 (2002). On the other hand, Item 402(c) requires statements to include "potential realizable value[s] of each grant of options" to executive officers, *id.;* but, notably, this provision does not apply to outside directors. Thus, the Court agrees with Defendants that no SEC regulation requires Black-Scholes.

Beyond that, even if Black-Scholes were reliable for purposes of tax regulations governing loans, it does not automatically follow that Black-Scholes calculations are material for purposes of determining whether a proxy

statement is false or misleading.[6] As a result, the Ninth Circuit's ruling in *Custom Chrome* does not diminish the persuasive weight of the four cases that have dismissed claims identical or similar to Plaintiff's.

Plaintiff's main argument to the contrary is that the Court should assume as true his allegation that Black-Scholes is applicable to the options at issue, and that the courts that have ruled on the matter improperly delved into factual issues on motions to dismiss. However, there is no reason to conclude that all four courts incorrectly applied the standard for ruling on a motion to dismiss.[7] Moreover, even if the Court were to accept that Black-Scholes were applicable to the options in this case, that does not mean that it must therefore assume as true Plaintiff's assertion that he has stated a valid claim for relief. Whether factual allegations are legally sufficient to state a claim cannot be assumed from the face of a complaint; indeed, that is exactly what a court must decide on a motion to dismiss.

---

6. Similarly, whether Black-Scholes calculations would pass all evidentiary standards required for admissibility under *Kumho Tire* is inapposite. *See Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999) (describing rules for admissibility of expert testimony). The Court notes with disapproval that Plaintiff presented this argument only at oral argument and not in his written opposition. However, even if Plaintiff's argument is correct—which this Court need not decide—the admissibility of Black-Scholes valuations does not make such calculations material for purposes of Rule 14a-9 analysis.

7. The state courts applied state procedural law, but the respective standards for dismissal are the same as for Rule 12(b)(6)—i.e., accept all factual allegations as true.

Based on the persuasive case law presented by Defendants, and the lack of convincing rebuttal by Plaintiff, this Court rules that, as a matter of law, Black-Scholes valuations are not material for purposes of Rule 14a-9 analysis. Consequently, Plaintiff has not stated a claim for relief, and the Court hereby GRANTS Defendants' motion to dismiss as to this claim. Because omissions must be material in order to be actionable, and Black-Scholes valuations are not material, it is clear that Plaintiff cannot allege any facts that would allow him to state a claim under this theory. Dismissal is therefore with prejudice.[8] *Cf. Resnik*, 2001 WL 15671 at *1 (S.D.N.Y. case dismissing similar claims with prejudice).

Failure to Disclose All Federal Tax Consequences

Plaintiff's second allegation is that the proxy statement is misleading because it fails to disclose all federal tax consequences when it describes the options' federal income tax consequences. However, as Defendants recognize and Plaintiff does not refute, no law or regulation requires Defendants to include the potential treatment of the option grants under the federal estate tax, gift tax, or generation-skipping transfer tax. Nor have Defendants falsely stated that the options have no consequences under these three tax

8. Plaintiff argues that his need to conduct further discovery should prevent dismissal of this case with prejudice. However, the Ninth Circuit has expressly stated that complaints in actions such as this one must be able to stand "on the actual knowledge of the plaintiffs rather than information produced by the defendants after the action has been filed." *Medhekar v. United States District Court*, 99 F.3d 325, 328 (9th Cir. 1996) (per curiam).

schemes. As a result, Plaintiff's allegation can only give rise to a claim if omission of these tax consequences renders some other statement in the proxy statement false or misleading.

Plaintiff alleges that Defendants' omission renders misleading Defendants' representation that the option grants have no federal income tax consequences at the time of issue. The Court agrees with Defendants that this allegation is illogical. Stating that an act has no federal *income* tax consequences does not imply that the act has absolutely no federal tax consequences whatsoever. Plaintiff therefore fails to state a claim. *Cf. Stricklin v. Ferland,* No. Civ. A. 98-3279, 1998 WL 966023 at *7 (E.D.Pa. Nov. 10, 1998) (plaintiff who alleges that the proxy statement could have included additional information, without alleging anything to explain why the statement, as is, was materially misleading, fails to state a claim under Section 14(a)). Accordingly, the Court hereby GRANTS Defendants' motion as to this claim. Dismissal is with prejudice because it is clear that Plaintiff could not cure the deficiencies of his complaint even if given leave to amend.

CONCLUSION

For the above reasons, this Court GRANTS Defendants' Motion to Dismiss. Plaintiff's complaint is dismissed, with prejudice, in its entirety.

Appendix B

IT IS SO ORDERED.

DATED 2/8/02

s/ Thelton E. Henderson
Thelton E. Henderson, Judge
UNITED STATES DISTRICT COURT

APPENDIX C — STATUTORY AND REGULATORY PROVISIONS INVOLVED

15 U.S.C. § 78n

§ 78n. Proxies

(a) Solicitation of proxies in violation of rules and regulations

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

* * * *

Appendix C

17 C.F.R. § 240.14a-9

§ 240.14a-9 False or misleading statements.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(b) The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

* * * *

Appendix C

17 C.F.R. § 240.14a-101
SOLICITATION OF PROXIES

§ 240.14a-101 Schedule 14A. Information required in proxy statement.

* * *

Item 8. Compensation of directors and executive officers. Furnish the information required by Item 402 (§ 229.402 of this chapter) of Regulation S-K if action is to be taken with regard to:

(a) The election of directors;

(b) Any bonus, profit sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the registrant will participate;

* * *

(d) The granting or extension to any such person of any options, warrants or rights to purchase any securities, other than warrants or rights issued to security holders as such, on a pro rata basis.

* * *

Appendix C

Item 10. Compensation Plans. If action is to be taken with respect to any plan pursuant to which cash or noncash compensation may be paid or distributed, furnish the following information:

(a) Plans subject to security holder action.

(1) Describe briefly the material features of the plan being acted upon, identify each class of persons who will be eligible to participate therein, indicate the approximate number of persons in each such class, and state the basis of such participation.

(2)(i) In the tabular format specified below, disclose the benefits or amounts that will be received by or allocated to each of the following under the plan being acted upon, if such benefits or amounts are determinable:

Appendix C

New Plan Benefits		
Plan name		
Name and position	Dollar value ($)	Number of units
CEO.		
A.		
B.		
C.		
D.		
Executive Group.		
Non-Executive Director Group.		
Non-Executive Officer Employee Group.		

(ii) The table required by paragraph (a)(2)(i) of this Item shall provide information as to the following persons:

* * *

(C) All current directors who are not executive officers as a group; and

* * *

Appendix C

(iii) If the benefits or amounts specified in paragraph (a)(2)(i) of this item are not determinable, state the benefits or amounts which would have been received by or allocated to each of the following for the last completed fiscal year if the plan had been in effect, if such benefits or amounts may be determined, in the table specified in paragraph (a)(2)(i) of this Item:

* * *

(C) All current directors who are not executive officers as a group; and

* * *

Instructions

* * *

2. If action is to be taken with respect to a material amendment or modification of an existing plan, the item shall be answered with respect to the plan as proposed to be amended or modified and shall indicate any material differences from the existing plan.

* * * *

Appendix C

17 C.F.R. § 229.402
REGULATION S-K

§ 229.402 (Item 402) Executive Compensation.

* * *

Instruction to Item 402(b)

* * *

(c) Option/SAR Grants Table.

(1) The information specified in paragraph (c)(2) of this item, concerning individual grants of stock options (whether or not in tandem with SARs) and freestanding SARs (including options and SARs that subsequently have been transferred) made during the last completed fiscal year to each of the named executive officers shall be provided in the tabular format specified as follows:

[Table omitted]

(2) The Table shall include, with respect to each grant:

* * *

Appendix C

(vi) Either (A) the potential realizable value of each grant of options or freestanding SARs or (B) the present value of each grant, as follows:

* * *

(B) The present value of the grant at the date of grant, under any option pricing model (alternative column (f)).

Instructions to Item 402(c)

* * *

9. Where the registrant chooses to use the grant-date valuation alternative specified in paragraph (c)(2)(vi)(B) of this item, the valuation shall be footnoted to describe the valuation method used. Where the registrant has used a variation of the Black-Scholes or binomial option pricing model, the description shall identify the use of such pricing model and describe the assumptions used relating to the expected volatility, risk-free rate of return, dividend yield and time of exercise. Any adjustments for non-transferability or risk of forfeiture also shall be disclosed. In the event another valuation

method is used, the registrant is required to describe the methodology as well as any material assumptions.

* * *

(g) Compensation of Directors—

(1) Standard arrangements. Describe any standard arrangements, stating amounts, pursuant to which directors of the registrant are compensated for any services provided as a director, including any additional amounts payable for committee participation or special assignments.

(2) Other arrangements. Describe any other arrangements pursuant to which any director of the registrant was compensated during the registrant's last completed fiscal year for any service provided as a director, stating the amount paid and the name of the director.

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Instruction to Item 402(g)(2)

The information required by paragraph (g)(2) of this item shall include any arrangement, including consulting contracts, entered into in consideration of the director's service on the board. The material terms of any such arrangement shall be included.

* * * *

Supreme Court, U.S.
FILED
JUL 7 2003
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No. 02-1779

In The Supreme Court of the United States

GREG SEINFELD,

Petitioner,

vs.

CAROL A. BARTZ, JOHN T. CHAMBERS, MARY A. CIRILLO, DR. JAMES F. GIBBONS, EDWARD R. KOZEL, JAMES C. MORGAN, JOHN P. MORGRIDGE, ARUN SARIN, DONALD T. VALENTINE, STEVEN M. WEST and CISCO SYSTEMS, INC.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENTS' OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

KEVIN P. MUCK *
JAMES A. LICO
CATHERINE DUDEN-KEVANE
CLIFFORD CHANCE US LLP
Attorneys for Respondents
One Market, Steuart Street Tower
San Francisco, CA 94105
(415) 778-4700

* *Counsel of Record*

COCKLE LAW BRIEF PRINTING CO. (800) 225-6964
OR CALL COLLECT (402) 342-2831

19 pp

QUESTION PRESENTED

Where a public company proxy statement seeks shareholder approval of compensation proposed to be granted to the corporation's non-employee directors in the form of stock options, does Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act"), or Rule 14a-9 promulgated by the Securities and Exchange Commission ("SEC") thereunder, require the proxy statement to include a theoretical dollar valuation of those options?

If not, was the 1999 proxy statement issued by Cisco Systems, Inc., otherwise materially misleading because it did not include such theoretical valuations?

CORPORATE DISCLOSURE

Pursuant to Supreme Court Rule 29.6, Cisco Systems, Inc. states that it has no parent corporation and no publicly held company owns 10% or more of Cisco's stock.

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Financial Accounting Standards Board Statement No. 123 11

STATEMENT OF THE CASE

In 1999, the Board of Directors of Cisco Systems, Inc. ("Cisco" or the "Company"), proposed to increase the non-cash compensation to be awarded the Company's non-employee ("outside") directors beginning in fiscal 2000, by amending the Company's Automatic Option Grant Program. That proposal was detailed in the Company's proxy statement. New non-employee directors would receive initial option grants of 30,000 shares (subject to vesting requirements), rather than 20,000. With each year of continued service thereafter, non-employee directors were to receive annual grants of 15,000 shares (again, subject to vesting), rather than 10,000. As Petitioner notes (Pet. at 2-3), the options expire nine years after grant or one year after the director leaves the board, whichever occurs first. The proxy statement also disclosed the compensation paid each director for fiscal 1999: $32,000 in cash, and options to purchase 10,000 shares of Company stock.

Plaintiff sued Cisco's directors, claiming that these disclosures were materially false and misleading because Cisco did not include in the proxy statement a theoretical dollar valuation of the option compensation calculated using the Black-Scholes option pricing model. He argued that such a disclosure was required both expressly by Section 14(a) of the Exchange Act and SEC Rule 14a-9 and because certain statements in Cisco's proxy were allegedly materially misleading by virtue of its omission.

The courts below had no trouble reaching the conclusion that such a disclosure was not required by statute or rule, and that Petitioner failed to demonstrate that Cisco's proxy statement was materially misleading by omission. Accordingly, the United States District Court for the

Northern District of California dismissed Petitioner's complaint. The Ninth Circuit Court of Appeals affirmed the dismissal in a published opinion.

Petitioner's statement of the case now suggests that the underlying lawsuit has to do with accounting standards – *i.e.*, whether stock option compensation granted to corporate officers and directors should be recorded by the issuing corporations as an expense against income and, if so, in what manner. Pet. at 5.

But this lawsuit has nothing to do with those issues. Those matters (as the Petition discloses) are being debated in the pages of the *Wall Street Journal*, in the councils of the Financial Accounting Standards Board, and elsewhere. The question of whether and how option compensation should be recorded on the corporation's books is not the question presented here. The question actually presented by this case is whether estimates of the value of proposed director option grants, calculated using the Black-Scholes option pricing model, must be included in the corporation's proxy statement when the corporation seeks shareholder approval of a proposed compensation plan.

Petitioner here is asking this Court to do two things. First, he seeks to impose an obligation on companies, under Section 14(a) of the Exchange Act, to include theoretical valuations of director compensation in proxy statements – although neither the Congress nor the SEC has done so. Second, he proposes to require that those estimated valuations be derived in a particular way – by the Black-Scholes option pricing model – although each federal and state court that Petitioner's counsel has urged to do this has declined the invitation, in several instances

noting the hazard that such a use of the model could produce potentially misleading results.

REASONS FOR DENYING THE WRIT

This case presents no compelling reason for certiorari review. There is no circuit split for this Court to resolve, and no important question of federal law that this Court needs to decide. Petitioner's "question presented" – which is really one of regulatory policy, not federal law – is simply not presented by the record below.

The only question truly presented here is whether the Ninth Circuit erred in affirming dismissal of Petitioner's claim that Cisco's proxy statement was materially misleading and violated Section 14(a) of the Exchange Act or SEC Rule 14a-9 merely because it did not include Black-Scholes valuations of outside directors' option grants. The Ninth Circuit was perfectly capable of addressing this question, and did so. That Petitioner believes the Ninth Circuit's rejection of his theory was – like the decisions of all of the other courts that have ruled against his counsel – "wrong, and for a variety of bad reasons" (Pet. at 8) is no reason for this Court to grant review.

I.

THERE IS NO SPLIT OF AUTHORITY FOR THIS COURT TO RESOLVE, AND NO IMPORTANT QUESTION OF FEDERAL LAW PRESENTED BY THE DECISION BELOW

There were two basic issues presented to, and decided by, the courts below. Both are straightforward: (1) Does

Section 14(a) of the Exchange Act or SEC Rule 14a-9, require the inclusion of a theoretical dollar valuation of stock option compensation to non-employee directors? (2) If the inclusion of such theoretical dollar valuations is not affirmatively required, was Cisco's Proxy Statement otherwise materially misleading for failing to include such theoretical valuations?

The only possible general question of federal law presented is the first one, and Petitioner has done nothing to show that the lower federal courts need any help answering it. Petitioner, for example, does not contend that there is a split of authority in the lower courts. Indeed, he is compelled to admit the contrary: *i.e.*, that every court to have considered Petitioner's theory has rejected it. Pet. at 8. Two Courts of Appeals have been faced with the efforts of Petitioner's counsel to impose a Black-Scholes disclosure requirement via Section 14(a) of the Exchange Act, the Ninth and the Second. Both concluded in thorough, published opinions that the disclosure requirement urged by Petitioner does not exist. *Seinfeld v. Bartz*, 322 F.3d 693 (9th Cir. 2003); *Resnik v. Swartz*, 303 F.3d 147 (2d Cir. 2002). Their decisions are consistent with those of two federal district courts and the state courts of Delaware and New York. *See Seinfeld v. Bartz*, No. C-01-2259, 2002 WL 243597 (N.D. Cal. Feb. 8, 2002), *aff'd*, 322 F.3d 693 (9th Cir. 2003); *Resnik v. Swartz*, No. 00 Civ. 5355, 2001 WL 15671 (S.D.N.Y. Jan. 8, 2001), *aff'd*, 303 F.3d 147 (2d Cir. 2002); *Shaev v. Hampel*, No. 99 Civ. 10578, 2002 WL 31413805 (S.D.N.Y. Oct. 25, 2002); *Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 1997); *In re 3Com Corp. S'holders Litig.*, No. C.A. 16721, 1999 WL 1009210 (Del. Ch. Oct. 25, 1999); *Cohen v. Calloway*, 246 A.D.2d 473 (N.Y. 1998).

As the Petition obliquely discloses, Cisco is but one of several companies against which Petitioner's counsel has sought to test his theory that any proxy statement omitting Black-Scholes estimated valuations of director option compensation is materially misleading. Indeed, in suggesting that this Court's intervention is required, the Petition admits (apparently without irony) that "Only the courts have addressed this issue and only at the urging of petitioner's counsel." Pet. at 8. Yet Petitioner fails to show that the lower federal courts have failed to do their jobs, let alone in such an egregious manner that this Court need step in and get them in line.

This case simply presents no important question of federal law. None of the courts whose jurisdiction has been invoked by Petitioner (including the Ninth Circuit here) has encountered any difficulty construing the relevant statutes and regulations. None struggled to conclude that neither Section 14(a) of the Exchange Act nor SEC Rule 14a-9 requires the inclusion of Black-Scholes theoretical valuations of director option compensation in proxy statements.

Petitioner nevertheless requests the intervention of this Court because he believes these other courts were all "wrong and for a variety of bad reasons." Pet. at 8. Even if this were true, it would not constitute a basis for certiorari review of the instant Ninth Circuit opinion. *See Nat'l Labor Relations Board v. Pittsburgh S.S. Co.*, 340 U.S. 498, 503 (1951) ("This is not the place . . . to reverse a Court of Appeals because were we in its place we would find the record tilting one way rather than the other . . . .").

Nor is the far-fetched suggestion that the Black-Scholes option pricing model will not be "free of suspicion

by the public, unless this court [sic] decides that those courts are wrong" (Pet. at 11) a reason to grant review. Putting aside the fact that Petitioner's argument is based on the demonstrably false premise that the Ninth Circuit somehow disparaged the Black-Scholes model (*id.* at 1), certiorari should not be granted to endorse a particular resolution of an ongoing debate among financial professionals, companies and regulators about arcane matters of accounting and economic modeling on a record that does not even present the issue, let alone because of speculation that "the public" may view its resolution with skepticism as a result of the opinion below. *See New York v. Uplinger*, 467 U.S. 246, 249 (1984) (certiorari should not be granted where issue is not ripe, even in presence of "important constitutional issues"). That is especially true where, as here, there is a regulatory body – the SEC – charged with responsibility for determining the appropriate scope of corporate disclosures and uniquely situated to discharge that responsibility. As the Delaware Chancery Court put it, "[j]udgments concerning what disclosure, if any, of estimated present values of options should be mandated are best made . . . by an agency with finance expertise" – namely, the SEC – rather than the courts. *Lewis*, 699 A.2d at 332-33.

II.

NEITHER THE RECORD NOR THE DECISION BELOW RAISES THE QUESTION PRESENTED BY THE PETITION

The Petition really attempts to present a question of regulatory policy: whether investors who are asked to vote on outside director compensation proposals would benefit from the required inclusion of Black-Scholes theoretical

option valuations in deciding how to vote. The Petition concedes this. Pet. at 5-6.

That, however, is not a question of what existing laws or regulations *do* require, or even a question of whether the court below got those requirements wrong. It is, rather, a question of what the regulations *should* require, and that is a matter for legislators or regulators – not the courts – to address in the first instance. The lower courts have (correctly) recognized this, as the Petition acknowledges. Pet. at 10-11. Petitioner, however, asks this Court to act as the judicial rule-maker of first resort, because his counsel has been heretofore unable to persuade any lower court to invade the province of Congress and the SEC in this manner.

Even if the question presented were one of federal law, it is not an *important* one. To be "important" the issue involved must "reach to a problem beyond the academic or the episodic"; it is not enough that it be "intellectually interesting." *Rice v. Sioux City Mem'l Park Cemetery*, 349 U.S. 70, 74 (1955). Whether the Black-Scholes option pricing model can be adapted to produce reliable valuations of the options granted to non-employee directors may be a question of interest to economists, or even securities regulators considering additional disclosure requirements, but it is not an issue for this Court to decide.

III.

THE NINTH CIRCUIT DID NOT ERR

Although arguing that the lower court's decision was erroneous "is ordinarily not sufficient reason" for issuing a writ of certiorari, *Ticor Title Ins. Co. v. Brown*, 511 U.S.

117, 122 (1994), it is still significant that Petitioner is unable to demonstrate any error here. In rejecting the theory that Cisco's proxy statement was materially misleading in the absence of theoretical valuations of outside directors' options, the Ninth Circuit – like the Second Circuit and, apparently, every district court and state court to have considered the question – was guided by the plain language of the relevant statute and applicable rules and regulations.

Section 14(a) of the Exchange Act prohibits solicitation of proxies "in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. § 78n(a). SEC Rule 14a-9 proscribes making materially false statements in proxy materials, or "omit[ting] to state any material fact necessary in order to make the statements therein not false or misleading." 17 C.F.R. § 240.14a-9(a). "Thus, omission of information from a proxy statement will violate these provisions if either the SEC regulations specifically require disclosure of the omitted information in a proxy statement, or the omission makes other statements in the proxy statement materially false or misleading." *Resnik*, 303 F.3d at 151.

The Ninth Circuit correctly held that Petitioner failed to identify any rule or regulation directing issuers to include theoretical valuations of outside directors' options in proxy materials, or that the omission of such estimates rendered any statement in Cisco's proxy materials false or misleading. Schedule 14A, 17 C.F.R. § 240.14a-101, and Item 402 of Regulation S-K, 17 C.F.R. § 229.402, specify the information concerning directors' options that must be included in proxy statements. Item 8 of Schedule 14A ("Compensation of Directors and Executive Officers")

states that when action is to be taken in connection with, *inter alia*, the grant of options to directors or executive officers, the proxy statement must contain the information required by Item 402. 17 C.F.R. § 240.14a-101. As both the Second and Ninth Circuits have noted, neither Schedule 14A nor any portion of Item 402 requires issuers to provide estimated valuations of options granted to outside directors. *Seinfeld*, 322 F.3d at 698; *Resnik*, 303 F.3d at 152. Indeed, while Item 402(g) spells out the information that must be furnished with respect to the compensation of directors, and requires disclosure of fees received by directors and the options proposed to be awarded to them, it makes no mention of grant-date valuation of such proposed options. *Seinfeld*, 322 F.3d at 698; *Resnik*, 303 F.3d at 152.

Moreover, Item 402(c) requires registrants to calculate "potential realizable value" (based on a set of specified assumptions) for option grants to certain *executive officers*, but imposes no similar requirement for directors.[1] Thus, inasmuch as the SEC has specifically addressed the information regarding director compensation that must be provided in proxy statements, and determined what information should be required with respect to the valuation of option grants, "'[t]he absence of any mention of option values or of valuation methods from subsection (g), Compensation of Directors, is persuasive evidence that the

[1] Significantly, even with respect to executive officers' option grants, the SEC does not require use of the Black-Scholes formula. *Seinfeld*, 322 F.3d at 698. *See also Lewis*, 699 A.2d at 332 n.9. To the extent that Petitioner suggests otherwise (Pet. at 11), he misreads Item 402(c), which permits – but does not require – use of Black-Scholes to value grants to executive officers. 17 C.F.R. § 229.402(c).

[SEC] did not intend subsection (g) to require disclosure of grant-date value calculation for the options proposed to be awarded to non-employee directors.'" *Seinfeld*, 322 F.3d at 698 (quoting *Resnik*, 303 F.3d at 152).[2]

Nor is there any basis to disturb the Ninth Circuit's determination that Petitioner failed to plead facts establishing that the absence of theoretical valuations of outside directors' option grants made any statement in Cisco's proxy materials false or misleading. Petitioner principally challenges Cisco's statement that, "Unless the market value of the Common Stock appreciates over the option term, no value will be realized from the option grants made to executive officers" (*Seinfeld*, 322 F.3d at 698), which he mischaracterizes as a representation that an "option has 'no value' . . . unless the stock price increases." Pet. at 10. First and foremost, Petitioner is unable to explain how the statement actually made by Cisco – which does not intimate that options have "no value" or opine as to their value – is a "half-truth" or otherwise inaccurate in any way. *See Resnik*, 303 F.3d at 154 (holding that a similar statement is not actionable because it "accurately describes how value is realized when options are actually exercised"); *3Com*, 1999 WL 1009210, *6-7 (statement that "[n]o gain . . . is possible

[2] Petitioner's contention that the Ninth Circuit "overlooked" Item 10 of Schedule 14A is inaccurate. There is no mention in Item 10 of Black-Scholes or any other option pricing model, much less a directive that companies use such models to provide estimated valuations of option grants to directors. 17 C.F.R. § 240.14a-101. Accordingly, far from supporting Petitioner's position, Item 10 actually provides further confirmation that the SEC has deliberately elected not to require registrants to include such estimates in proxy statements.

without an increase in stock price" is "true on its face, even standing alone").

Nonetheless, Petitioner asserts that the challenged statement is misleading in the absence of estimated valuations, because Financial Accounting Standards Board ("FASB") Statement No. 123 purportedly approves of the use of the Black-Scholes pricing model. *See Seinfeld*, 322 F.3d at 698; Pet. at 10. However, FASB No. 123 concerns year-end financial statements and does not purport to address the requirements for proxy statements, and therefore "is not relevant to the issue presented here." *Seinfeld*, 322 F.3d at 698. *See also Resnik*, 303 F.3d at 153; *Lewis*, 699 A.2d at 332-33. While Petitioner ostensibly disputes this conclusion (Pet. at 12), he tellingly fails to cite any case, rule, regulation, commentator or other authority suggesting that FASB No. 123 has any application to proxy materials or the information required to be included therein. In any event, as the Ninth Circuit explained, the challenged statement relates solely to options granted to executive officers, and is "completely unrelated to the amendments to the plan [Petitioner] is challenging, which concerned options proposed to be granted to outside directors." *Seinfeld*, 322 F.3d at 698. *See also Resnik*, 303 F.3d at 154 (statement concerning executive officers' options "does not purport to make any representations

about the options proposed to be granted to the non-employee directors under the Plan").[3]

CONCLUSION

This Court should not occupy its time with administrative rule-making – especially when there exists a responsible administrative agency, with financial expertise, charged by Congress with this duty. The Ninth and

[3] Furthermore, although the Ninth Circuit had no need to reach the issue, there was another independent basis for affirming dismissal of Petitioner's claims: he failed to demonstrate that Black-Scholes estimates of the value of outside directors' option grants were material. Black-Scholes is a formula designed to provide estimated valuations of publicly traded options. *Cramer v. C.I.R.*, 101 T.C. 225, 241 (1993), *aff'd*, 64 F.3d 1406 (9th Cir. 1995); *Lewis*, 699 A.2d at 331-32. By contrast, the options granted to Cisco's outside directors were not publicly traded or transferable, and were subject to vesting and other restrictions. Where options are subject to vesting and are granted to outside directors, whose service may cease at any time, it is not reasonably possible to determine an option's term (one of the key variables in the Black-Scholes model). *Lewis*, 699 A.3d at 331 n.8. As a result, the "model overstates the value of options that can be exercised at any time during their term." *Id.* at 331-32. Notably, while Petitioner asserts (without explanation) that such distortion is "'significantly overstate[d]'" (Pet. at 9), he does not dispute its existence. Moreover, option valuation models (including Black-Scholes) depend on subjective estimates of such factors as volatility. *Cramer*, 101 T.C. at 241. Accordingly, such models can produce a range of theoretical valuations – any of which could be challenged as speculative or even misleading, which is precisely what Petitioner's counsel has done in at least one other case. *See Shaev*, 2002 WL 31413805, at *6. Consequently, estimated valuations of the Cisco directors' option grants would not be viewed by the reasonable shareholder as "important in deciding how to vote," or "significantly alter[ing] the 'total mix' of information made available." *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Second Circuits both noted this in declining the invitations of Petitioner's counsel to do the work of the SEC. *Seinfeld*, 322 F.3d at 700; *Resnik*, 303 F.3d at 154-55.

There is no reason presented by the Petition to believe that Congress (which only recently passed a number of new disclosure requirements in the form of the Sarbanes-Oxley Act) or the SEC (which has been busily implementing these requirements with new rules) could not impose the disclosure requirement sought by Petitioner if indeed either of them concluded that this would benefit shareholders. *See Rice*, 349 U.S. at 77 ("in the absence of compelling reason, we should not risk inconclusive and divisive disposition of a case when time may further illumine or completely outmode the issues in dispute"). That they have not is no reason for this Court to assume the role of legislators or regulators.

The petition for writ of certiorari should be denied.

Respectfully submitted,

KEVIN P. MUCK*
JAMES A. LICO
CATHERINE DUDEN-KEVANE
CLIFFORD CHANCE US LLP
Attorneys for Respondents
One Market, Steuart Street Tower
San Francisco, CA 94105
(415) 778-4700

**Counsel of Record*

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San Francisco, California

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No. 02-1779

IN THE

Supreme Court of the United States

GREG SEINFELD,

Petitioner,

v.

CAROL A. BARTZ; JOHN T. CHAMBERS; MARY A. CIRILLO; JAMES F. GIBBONS; EDWARD R. KOZEL; JAMES C. MORGAN; JOHN P. MORGRIDGE; ARUN SARIN; DONALD T. VALENTINE; STEVEN M. WEST; and CISCO SYSTEMS, INC.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900

181967

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

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I. THE QUESTION IS IMPORTANT

The Respondents are unable to deny the critical economic importance to societal well being of institutional and individual holdings of corporate stock and the frequent and substantial effects on that wealth that result from stockholders' votes on stock option plans. The Respondents are unable to deny or to refute Chairman Greenspan's affirmations of the importance of disclosing the value of stock options.

The Question Presented addresses "a problem beyond the academic or episodic," (*Rice v. Sioux City Memorial Park Cemetery*, 349 U.S. 70, 74 (1955)) and presents "compelling reasons" for granting this petition. (Supreme Court Rule 10). It is not remotely, let alone "entirely hypothetical." *Ticor Title Insurance Co. v. Brown*, 511 U.S. 117, 118 (1994).

II. THE QUESTION SHOULD BE SETTLED BY THIS COURT

The Respondents make the demonstrably false statement that the Question Presented is the subject of "an ongoing debate among financial professionals, companies and regulators about arcane matters of accounting and economic modelling." (Resp. at 6.) In fact, there is no debate in that arena about Black-Scholes disclosures at the time of stockholder approval of stock options and plans to grant them, but only the question of how to report the expensing of those stock options after they are approved and granted. (Pet. at 6, 8.) There is no debate about the efficacy of the Black-Scholes model or similar binomial models to evaluate corporate stock options for directors, officers and employees,

at least among the informed. The only source of objection is from option holders who prefer that the public be ignorant of the amounts involved.

Moreover, we cannot expect that Congress or the SEC will address the Question Presented (Resp. at 13), for they have already done that. Accordingly, Supreme Court review of the Question Presented is necessary in order to correct repeated errors in the lower courts concerning the statutory and regulatory requirement that stock option values be disclosed when stockholder approval is sought, i.e., when disclosure will do the most good, and that values be determined according to the Nobel Prize winning Black-Scholes model or some equally good binomial model, as prescribed by the Financial Accounting Standard Board, whose function is approved by the Securities and Exchange Commission.

The Ninth Circuit made frequent disparaging comments about Black-Scholes, notwithstanding the Respondents' protestations to the contrary. (Resp. at 6.) That court at 7a noted that the stock warrants in its decision *Custom Chrome, Inc. v. Comm.*, 217 F.3d 1117, 1120 (9th Cir. 2000) were "in essence, options," which could be evaluated by Black-Scholes, but it then said:

> *Custom Chrome* in no way endorses the use of Black-Scholes to value options granted to outside directors, and it certainly does not require the use of Black-Scholes to value options for purposes of a proxy statement. Its reasoning simply is inapposite to the issue presented here.

The Ninth Circuit did not explore whether, apart from *Custom Chrome*, Black-Scholes would work on the stock options at bar.

Although FASB 123 endorses Black-Scholes for the kind of stock options at bar, the Ninth Circuit held, without a record of expert testimony, that FASB 123 applied to financial statements, not proxy statements. Again, the Ninth Circuit did not explore whether, apart from FASB 123, Black-Scholes would work, nor did it explain why the presentation of financial information, i.e., a proposed issue of stock options, which if approved would appear on future financial statements, was not in and of itself a financial statement. *Matter of Trump Hotels & Casino Resorts, Inc.*, 2002 WL 58566 (SEC Rel. No. 34-45287, January 16, 2002).

Finally, the Ninth Circuit (9a-10a) rejected FASB 123's conclusion that it is wrong (or, as Chairman Greenspan said, "flat wrong," *The Wall Street Journal*, p.C-3, May 9, 2003) to say that a stock option has no value unless there is a price increase in the underlying stock. The court (11a) went on to quote *Resnik v. Swartz*, 303 F.3d 147, 154 (2nd Cir. 2002) to say it "accurately describes how value is realized when options are actually exercised." Even the "actually exercised" language is wrong, for it overlooks the time value of deferring the time to pay the purchase price. Ciesielski, Editorial Commentary, "Another Options War", *Barron's* p.39 (May 5, 2003) 2003 WL-BARRONS 6977368. Even underwater stock options have value that can be extracted without exercising them, as shown by the recent events at Microsoft Corporation, a Washington corporation, covered extensively in *The Wall Street Journal* on July 9 and 10, 2003. Published before the Microsoft story, it was noted in the

Harvard Business Review that senior executives might "have enough at stake to contract with an investment bank to hedge their option positions without exercising prematurely." Bodie, Kaplan, Merton, "For The Last Time: Stock Options Are An Expense," *Harv. Bus. Rev.*, 2003 WL 9953511, in the segment "The Real Impact Of Forfeiture and Early Exercise" (March 1, 2003). It is true that one court compared such a hedge to gambling "at a racetrack" and keeping money on a hot stock to money in the bank. *In re 3Com Corp. Sh.Lit.*, 1999 WL 1009210 at *8 (Del.Ch. 1999). But that was in the heady time of October 1999, shortly before the bubble burst, and many billions of dollars were lost. The *3Com* court was one that took "a rather jaundiced view of . . . [Black-Scholes] valuations and their reliability." (at *4 n.7).

The Respondents attempt to justify the Ninth Circuit's narrow focus on Items 402(c) and (g) of 17 C.F.R. § 229. They contend that Item 10 of 17 C.F.R. § 240.14a-101 was properly unmentioned since it does not refer to "Black-Scholes or any other option pricing model." (Resp. at 10 n.2.) However, the Item 10 Table, reproduced at 30a, does require a report of the "Dollar value ($)" of the non-cash benefits. To report a dollar value of a stock option "requires using the Black-Scholes formula." Thomas and Martin, *The Determinants Of Shareholder Voting On Stock Option Plans*, 35 Wake Forest L.Rev. 31, 41 (2000). Moreover, it requires a disclosure of the dollar value of the proposed new benefits as if they had been in place the previous year if not determinable in the current year (17 C.F.R. 240.14a-101 (Item 10)(a)(2)(iii)(C)) reproduced at 31a (not 32a as erroneously stated at Pet. at 3). This provision of Item 10 eliminates the need for the distinction drawn below (7a-8a), between disclosure in a proxy statement and a year end financial statement. *See* Resp. at 11.

Respondents' repeated assertions that stock options cannot be valued, that Black-Scholes does not work (Resp. at 12 n.3), and their repeated, pejorative, epithetic term "theoretical" when referring to dollar valuations obtained by Black-Scholes are so hopelessly unscientific that there is no evidence for them that a court could admit under prevailing standards, e.g. *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999). "This Court has refused to accept assumptions of fact that are demonstrably false," no matter who agrees to it. *Universal Camera Corp. v. NLRB*, 340 U.S. 474, 497 (1951). These assertions underscore our point that this important issue should be settled by the Supreme Court.

The need for the settlement by the Supreme Court of the Question Presented is based upon the total rejection by the lower courts of the legal standards concerning principles of economic science and accounting that are universally accepted by thoughtful, respected, disinterested authorities, e.g., the Financial Accounting Standard board, Chairman Alan Greenspan, the Securities and Exchange Commission, the Internal Revenue Service (in Rev. Rul. 98-21 and Rev. Proc. 98-34), and the world's financial markets (Chriss, *Black-Scholes and Beyond: Options Pricing Models*, (Irwin 1997), E5-7, 74). The Ninth Circuit did not simply make erroneous factual findings and misapply a properly stated rule of law. Rather, it failed to identify the correct rule of law. *Universal Camera Corp. v. NLRB*, *supra*, 340 U.S. at 491. By so doing, it has seriously compromised the efforts of the Financial Accounting Standards Board (with Chairman Greenspan's warm concurrence) to provide at least some important relief from the recent excesses cast upon our financial markets and our entire societal well being by false accounting. Accounting may be a dull subject and economics a dismal science, but if they are mishandled, they can wreak havoc.

Corporations are managed by boards of directors. Stockholders do not have much say. They elect directors, usually without a choice of candidates, and so with little effect. They vote on mergers and liquidation, which are rare events, and they vote on stock option plans, fairly frequently and with substantial economic consequences.

III. THIS IS A GOOD CASE TO SETTLE THE QUESTION

The facts at bar are good for settling the Question Presented. They include a proposal in which the board is interested, and the Proxy Statement dramatically understates the dollar value of the board members' annual compensation. It would have been painfully simple for the Respondents to have disclosed the previously calculated Black-Scholes value of the stock options granted in the previous year to the non-employee directors as if the Amendment had then been in effect and thereby have complied with 17 C.F.R. § 240.14a-101 (Item 10)(a)(2)(iii). *See*, Appendix at 31a.

The legal analysis of the lower court also makes this a good case for settling the Question Presented. It overlooked the statutory purpose to insure honest securities markets through full disclosure, and it construed the statute technically, restrictively, and narrowly, rather than flexibly, as required. *SEC v. Zandford*, 535 U.S. 813, 819-11 (2002).

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900

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SUPPLEMENTAL BRIEF FOR PETITIONER

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900

183161

COUNSEL PRESS
(800) 274-3321 • (800) 359-6859

3 pp

A RECENT DECISION ENHANCES THE IMPORTANCE OF THE QUESTION

In *Shaev v. Hampel*, 02-9453, September 17, 2003, the Second Circuit, by non-precedential summary order, affirmed dismissal of a complaint that alleged that a proxy statement made material misstatements and omissions as to the number of shares available under a stock incentive plan and also as to the cost of the plan. As the result of this decision, corporate boards need disclose neither the number of shares nor the cost of stock option plans when they solicit stockholder approval.

The Second Circuit order frustrates the expressed intention of Congress in enacting § 14(a) as found by this Court in *J.I. Case v. Borak*, 377 U.S. 426, 431-32 (1964):

> "Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." S.Rep.No. 792, 73d Cong., 2d Sess., 12; 377 U.S. at 431.

The Second Circuit's sole authority was *Resnik v. Swartz*, 303 F.3d 147 (2nd Cir. 2002), which does not address the number of shares issue, nor did the court cite 17 C.F.R. § 240.14a-101 (Item 10)(b)(2)(i)(A), which states:

> (2)(i) With respect to any specific grant of or any plan containing options, warrants or rights submitted for security holder action, state:
>
> (A) The title and amount of securities underlying such options, warrants or rights; . . .

The district court's opinion, *Shaev v. Hampel*, 2002 WL 31412805 (S.D.N.Y. 2002), was cited in the Petition and in the Opposition.

Even if the Second Circuit were correct, that the number of shares in a plan can be omitted from the proxy statement, it has enhanced the importance of the question. Its decision will promote a proliferation of plans of unknown size and with unknown cost. They will increase the harm to our capital markets which can expect increased uncertainty and volatility as even more information will be withheld.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

A. ARNOLD GERSHON
BALLON STOLL BADER & NADLER, P.C.
Attorneys for Petitioner
1450 Broadway
14th Floor
New York, New York 10018-2268
(212) 575-7900